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BEFORE THE

SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 582 (Sub No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

COMMENTS OF WILLIAMS ENERGY SERVICES

And Verified Statement of

Tom O'Connor
Snavely King Majoros O'Connor & Lee, Inc.
1220 L St. NW
Washington, DC 20005

Dated: May 16, 2000

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Williams Energy Services ("Williams"), by Counsel, respectfully submits these comments in response to the Surface Transportation Board's (Board or STB) decision of March 17 and its Advance Notice of Proposed Rulemaking ("ANPR"), served March 17, 2000.

Williams Energy Services

Williams Energy Services is a wholly owned subsidiary of The Williams Companies, Inc. of Tulsa, OK., which is a $20 billion company. Originally a natural gas pipeline company, the Williams Companies have now expanded in natural gas exploration, telecommunications, and energy-related manufacturing, distribution and

retailing. Williams Energy Services operates the Companies' non-pipeline energy activities through four business units, Exploration and Production, Midstream Gas and Liquids, Petroleum Services, and Energy Marketing and Trading.

Williams Energy Services is a major rail shipper, originating more than 13,000 carloads annually, a total that is likely to increase as the company expands through market growth and acquisitions. Williams is one of the largest producers of Liquefied Petroleum Gas ("LPG"), with rail shipments representing approximately four percent of the total rail market for petroleum products. A more complete description of Williams and its family of affiliates is provided in the attached Verified Statement of Tom O'Connor.

The Board's Notices

Williams supports the Board's decision to defer further merger considerations pending a complete review of its merger rules and approval procedures. Williams also agrees with the ANPR's assessment of the issues confronting the Board and, by extension, the railroad industry and the shipping public.

In his "Review of the Issues," Mr. O'Connor identifies three classifications of issues identified by the Board: those that definitely require changes, those that may require changes, and those that probably do not require changes. These comments focus on the first category of issues, those that require changes. Mr. O'Connor

identifies three such issues: downstream effects, the need to promote and enhance competition, and the impact of mergers on rail service.

Downstream Effects

Williams agrees with the Board that any further major mergers, such as the proposed combination of the Burlington Northern Santa Fe ("BNSF") with the Canadian National ("CN"), will definitely have further "downstream effects". Those downstream effects will no doubt take the form of further mergers, with the likely result that all of North America (north of the Rio Grande) will be served by only two transcontinental and transnational Class I railroads.

It is not altogether clear how the Board can deal with this issue in its rulemaking. In an ideal world, the Board would use the 15-month moratorium on merger applications to obtain all plans for further mergers by non-applicant railroads. This obvious difficulty with this proposal is that mergers require complex and time-consuming negotiations that cannot easily be prescribed within any fixed timetable. Moreover, the next "round" may in fact involve two rounds, first, combinations of U.S. and Canadian railroads, then combinations of eastern and western railroads. Even if the first round could be predicted, the second round probably could not, so the Board's approvals of railroad consolidations necessarily must take on something of a "case-by-case" review, the very procedure the Board would like to avoid.

If the Board cannot review all downstream mergers in the context of the BNSF/CN combination, it can at least write generic rules that will be applied to each of the remaining mergers. Those rules should, at a minimum, address forcefully the two other issues that the Board has stated its intention to audit, competition and rail service.

Competition

In his Verified Statement, Mr. O'Connor discusses the nature of competition in a market consisting of only two dominant firms, which he terms a "duopoly." Mr. O'Connor believes that duopoly competition is weak competition because each duopolist makes its competitive decisions with the other duopolist in mind. This means that any pricing move by one competitor is likely to be matched by the other, so that, from the duopolists' point of view, price competition is somewhat self-defeating. Moreover, as Mr. O'Connor points out, each railroad duopolist will have something of a vested interest in the continued health of the other. If one duopolist drives the other from the market, then the resultant monopoly would likely attract the unwanted attention of government lawyers and regulators.

The practical reality in the railroad industry is that many, if not most, shippers even now are served by only a single railroad, and that list will grow with each merger. Attachment B to Mr. O'Connor's testimony lists Williams' principal rail movements and shipping points according to the number of railroads serving them. By far the largest group is the sole-served origins and destinations. There is a short list of movements

where either the origin or the destination has two or more serving railroads. Finally, there is an even shorter list of points where the impending merger will reduce what little rail-to-rail competition exists. These data suggest that for most of Williams' rail traffic, the railroad duopoly will look more like a parallel monopoly, with the sole serving carrier capable of exerting very strong pricing power.

In light of the already diminishing availability of competition among the railroads, and the likelihood that that availability will diminish further, the Board must adopt pro-competitive rules and policies. The nature and scope of these rules and policies depends on the extent to which the Board is willing to promote competition. Williams suggests that there are three levels of pro-competitive commitment :

(1) to retain competition,

(2) to enhance competition, and

(3) to create competition.

Each commitment level involves very different sets of rules.

1. To Retain Competition

The very minimum level of Board commitment should be an effort to retain whatever rail-to-rail competition already exists. The rules that would enforce this objective should require that any location served by more than one railroad prior to merger must continue to be served by at least two railroads following the merger.

The Board should not undertake to specify the mechanisms for implementing this rule. The merging railroads must bear the responsibility for finding the tools by which shippers can continue to access alternative carriers. Some are listed in Mr. O'Connor's testimony: trackage rights, haulage rights, joint operations, shared asset areas, and the exchange or sale of lines. The Board's role should be limited to ensuring that the alternative access arrangements effectively provide shippers with the same competitive rail alternatives they enjoyed prior to the merger. In this regard, it should be stated clearly that the merging railroads bear the burden of demonstrating that the same level of competition is maintained, and it should be the right of any shipper to challenge the adequacy of the railroads' solution.

2. To Enhance Competition

As noted earlier, and as demonstrated in Attachment B to Mr. O'Connor's testimony, the current level of rail-to-rail competition is already quite sparse. In the interest of creating a much-needed incentive for efficiency, the Board might consider using its merger rules as a mechanism for increasing competition among the surviving railroads. Mr. O'Connor discusses two strategies that would enhance competition without requiring any expansion of the Board's authority and or any modification in the structure of the railroad industry.

The first strategy is "interswitching," a principle that has been in effect in Canada, a country long accustomed to a rail duopoly. Under this principle, any shipper with access to only one railroad and located within a certain radius (30 km. in Canada) of a

railroad interchange point is entitled to equal access to either of the two railroads, regardless of the line on which he is actually located. The switching charges are prescribed, so that the shipper and the railroad are treated equitably.

The second strategy addresses single-carrier shipper locations outside the interswitching zones, where the serving carrier holds a "bottleneck" position with respect either to the origination or the termination of every movement. Mr. O'Connor proposes that any shipper in this situation should be entitled to test the bottleneck rate using generally accepted criteria, such as cost coverage. With a reasonable rate established, the freight could move either by the incumbent carrier or an alternate carrier; either to destination or to the nearest interchange point. In this manner, the shipper is able to isolate the portion of the through rate that is subject to the railroad's pricing power. The shipper would then be entitled to challenge that rate using established procedures such as the Board's revenue/costs ratio tests. While this strategy would not cure the shipper's single-railroad status, it would permit negotiation with the railroads for the competitive portion of the movement without the sole-server railroad extracting all of the revenue for the movement in the form of a bottleneck charge.

3. To Create Competition

The difficulty with the foregoing competitive enhancements is that they still leave us with a duopoly railroad market. If Mr. O'Connor's concerns over the inadequacy of duopoly competition are justified, then shipper access to the second railroad may not be enough to ensure vibrant and effective price and service competition. In this

circumstance, it may be necessary to consider steps to alter the structure of the railroad markets so as to allow other parties to enter as active competitors.

Mr. O'Connor discusses at some length the structural changes that have been implemented in the telephone, natural gas and electric utility industries; changes which created competition where none existed before. The most successful strategy has been open access, whereby parties other than the owner of the rights-of-way were allowed to use the incumbent's facilities on a cost-reimbursable basis. In some instances, the entities using the incumbent's line facilities are competitors, in other cases, the functions are "unbundled" so that the incumbent provides line service, while competing entities assemble and route the traffic (telephone messages, gas and electricity) over those lines.

It is probably premature and arguably inappropriate for the Board to consider structural changes to the railroad industry in the context of rewriting its merger guidelines. However, it is not too soon to convey to the railroads a concern that if their consolidation into two transcontinental systems results in uncompetitive prices and inadequate rail service, then structural solutions will be considered as a remedy.

Rail Service Quality

Recent railroad mergers have not been happy experiences for many shippers. Congestion, delayed and (worse) uncertain deliveries, lost cars, routing mix-ups and car shortages have made a mockery of the merging railroads' claims of improved efficiency

resulting from the merger. The Board is correct in its recognition that greater safeguards are needed to ensure against repetition of these problems in future mergers.

There are three stages to a merger. The first is the corporate stage, the easiest part. This involves the purchase or exchange of stock, changes in the Boards of Directors, and various design and organization tasks conducted by lawyers, financial consultants and other advisors. The second is the organizational merger. Previously separate departments are combined, the regional and sectional boundaries of the newly consolidated system are redrawn, and new officers and managers are appointed. This part is more difficult, particularly if the two railroads had very different organizational structures and corporate cultures.

The final stage is the operational merger, when the consolidated system attempts to operate as though it were always a single unit. This has been the phase of the recent railroad mergers that has created the greatest difficulties for shippers.

The Board's procedures do not recognize these three very different phases. When the Board approves a merger, the entire transaction is viewed as a whole. Once the corporate combination is approved, it is assumed that the organizational and operational consolidation will follow quickly and smoothly. This assumption has been proved wrong time after time.

Williams suggests that the Board's review and approval process might be taken in phases. First, the Board approves the corporate combination based on an

assessment of the long-term effect of further railroad consolidation. For a time, however, the two railroads continue to operate as separate entities. Then an organization consolidation is approved, based on a showing that the new company has ironed out problems of internal structure that might hinder its smooth operation.

Once the organizational merger is approved, the hard work of consolidation begins. The merging railroads must now demonstrate that they are able to function as a unit. This demonstration includes testing the computer and information systems, traffic control protocols, and car tracing systems using simulations of actual conditions. It requires the measurement of the tonnage capacities of each of its major corridors and comparisons with projections of traffic on the merged railroad. These demonstrations should be extensive, detailed, and if possible, opened to public scrutiny.

Only after this field testing and analysis has been complete should the railroads be allowed to merge their actual operations. Even then, the Board must compare the railroad's performance, on a regional and sectional – as well as system – basis against benchmarks established from pre-merger performance records.

Railroads are large and complex systems, and their mergers are correspondingly complex. It is unwise and unnecessary to hurry the process of consolidation. Merging railroads should be invited to establish extended implementation schedules, with milestones along the way beyond which they may not pass without having successfully met demanding operational tests. The process would better take several years than be

consummated in a matter of a few months and then require several subsequent years to resolve the problems created by undue haste.

Respectfully Submitted,
On behalf of

Williams Energy Services

By

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Suite 410
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Washington, DC

*Admitted to ICC practice, June 2, 1967

Before the Surface Transportation Board

Opening Statement on Selected Issues in STB Ex Parte No. 582 (Sub-No. 1 Major Rail Consolidation Procedures

Filed on Behalf of
Williams Energy Services

VERIFIED STATEMENT OF

Tom O'Connor
Vice President
Snavely King Majoros O'Connor & Lee, Inc.
1220 L St NW
Washington DC 20005

Dated: May 16, 2000

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I. EXECUTIVE SUMMARY

My name is Tom O'Connor. I am Vice President of the economic and management consulting firm of Snavely King Majoros O'Connor & Lee, Inc. I have served as an economist with the ICC, the USRA, Conrail, the AAR and two consulting firms, including my present firm.

I have been retained by Williams Energy Services to review the record of this proceeding and to analyze the STB's present and prospective role in the impending consolidation of the railroad industry. I have been asked to offer recommendations on rule revisions that could retain, and possibly enhance existing intra-modal competition and avoid the service disruptions that have characterized recent rail mergers.

Williams Energy Services is the wholly owned subsidiary of The Williams Companies, Inc. that operates the parent company's non-pipeline energy activities. It has four business units, Exploration and Production, Midstream Gas and Liquids, Petroleum Services, and Energy Marketing and Trading.

Williams Energy Services is a major rail shipper, originating more than 13,000 carloads annually, a total that is likely to increase as the company expands through market growth and acquisitions. Williams is one of the largest producers of Liquefied Petroleum Gas ("LPG"), with rail shipments representing approximately four percent of the total rail market for petroleum products.

The STB decision of March 17, 2000 and its Advance Notice of Proposed Rulemaking (ANPR) served on March 31, 2000 indicate fairly clearly that the Board intends to revise its merger rules in three respects: (1) recognition of downstream effects, (2) promoting and enhancing competition, and (3) maintaining efficient rail service. My statement addresses these three issues.

With respect to downstream effects, I agree with the STB that the next round of rail mergers is likely to create a transcontinental (U.S. and Canada) rail duopoly.

- **I recommend** that the STB recognize and remedy the fact that this duopoly will provide weak intra-modal competition.

In fact, given the duopoly, the STB may eventually have to reconsider the competitive structure of the industry. I discuss the analogous structural changes that have taken place in the telephone, natural gas and electric utilities industries, and I suggest that a similar restructuring may ultimately be required to create effective competition within the railroad industry.

With respect to competition, I explore six policy options available to the STB. **The first policy option** is maximum rate regulation, which addresses the potential abuse of market power in a highly concentrated railroad industry. I find this alternative to be inefficient, costly to all parties, and inconsistent with the recent trend of allowing markets, rather than regulators, to set efficient prices.

The fifth policy option is a set of procedures, short of full open access. There are a range of limited open access solutions to the threatened loss of intra-modal competition. These include trackage rights, haulage rights, joint facilities, shared service areas, and two concepts pioneered in Canada, interswitching and competitive line rates.

- **I recommend** that these approaches, all of which are within the STB's regulatory authority, be adopted aggressively as conditions for future mergers.

The sixth policy option is the one that the STB rightly has rejected, that of relying principally on regulatory oversight after the mergers are consummated. As a device for preserving competition, this approach focuses on the narrow specifics of each merger without considering the systemic decline in intra-modal competition throughout the continent.

While merger oversight is critical in ensuring that a given merger does not degrade the quality of service to shippers, effective oversight must begin well before the operational phase of the merger. Examples of needed preliminary work would include a demonstration that the car identification and tracing programs, and the operational data and computer systems have been "merged" in a simulated setting. The STB's operating benchmarks should also be set before the merger, based on pre-merger performance, and they should be refined to detect shortcomings at the regional and local, as well as system, levels. Additionally, the merging railroads should be required to calculate maximum tonnage densities for all major corridors, so as to identify ahead of time potential points of congestion.

Finally, the STB must address potential problems created by the merger of U.S. with Canadian railroads. These problems relate to the absence of uniform reporting of operating and financial data and common levels of disclosure. Without continent-wide uniformity, it will be impossible to assess the financial and operating characteristics of the merged railroads.

II. Introduction

A. Statement of Qualifications

My name is Tom O'Connor and I am Vice-President of Snavely King Majoros O'Connor & Lee (Snavely King), an economic and management consulting company. I have been engaged in the business of economic analysis for more than twenty-five years, beginning in 1973 as an economist with the Interstate Commerce Commission (ICC), predecessor of the Surface Transportation Board (STB) and later in economic analysis, transportation management and consulting positions of increasing responsibility with the United States Railway Association (USRA), Conrail, the Association of American Railroads (AAR), DNS Associates and, since 1987, with Snavely King Majoros O'Connor & Lee, an economic and management consulting company. I was Vice President of DNS Associates and have been Vice President and principal of Snavely King since joining the firm.

I have previously provided testimony in a number of proceedings before courts and regulatory commissions in the United States and Canada including US District Court for Eastern District of Virginia, the Interstate Commerce Commission, the Surface Transportation Board, The United States Railway Association, Regulatory Commissions in New York, and Pennsylvania, State Courts in Montana and

Virginia, Arbitration Panels in New York and Massachusetts and a Canadian Crown Commission. A detailed statement of my qualifications is contained in Appendix A to this statement.

B. Williams Energy Services

1. Rail Freight Scope and Volume

Since 1998, I have provided various technical advisory services to Williams Energy Services and one of its predecessor companies, which Williams subsequently acquired. These projects have centered on rail transportation.

Williams Energy Services now ships more than 13,000 rail carloads annually. Significantly more rail potential exists and more is being created through expansion and acquisitions. Williams is concerned with maintaining and improving rail service on its primary rail corridors which currently carry shipments originating in:

- Memphis, TN
- Pekin, IL
- Aurora, NE
- Dragon, MS
- Geismar, LA
- Conway, KS
- Hutchinson, KS
- Mont Belvieu, TX
- Breaux Bridge, LA
- Regina, SK Canada

- Sarnia, ON Canada
- Edmonton, AB Canada

...and more

In addition to these origins Williams also ships significant volumes from a second set of origins, some of which goes by rail. Williams is concerned with maintaining and improving rail service on rail corridors originating at the following points:

- Dallas, TX
- Houston, TX
- Marero, LA
- Charlotte, NC
- Des Moines, IA
- Sioux City IA,
- Kansas City, KS
- Mankato, MN
- St Paul, MN
- Omaha, NE,
- Opal, WY
- ...and more

Williams also currently ships significant volumes from a third set of origins. These origins are now largely or exclusively served by modes other than rail. Williams is interested in preserving and developing the potential for rail service on corridors originating at these points:

- Jacksonville, FL

- Augusta, GA
- Doraville, GA
- Meridian, MS
- Montgomery, AL
- Chattanooga, TN
- Nashville, TN
- Greensboro, NC
- Spartanburg, SC
- ...and more

And there is a fourth set of rail points with which Williams is concerned. Williams is a growing company and has recently acquired assets which generate significant rail volume. Moreover, they see the potential for synergies since some of the destination points on the new traffic are also origin points on their existing rail freight.

The newly acquired points generate rail traffic over rail corridors terminating at multiple destinations in the following states:

Destination	
State	**State**
WA	WI
CO	ND
OR	MT
ID	KS
NE	MN
ID	WY
NE	OR

Williams Energy Services is one of the largest producers in the Liquefied Petroleum Gases (LPG) industry with rail shipments representing approximately 4% of the total rail market in petroleum products[1].

Its objectives include maintaining a leadership position and pursuing additional value through more efficient and more extensive use of rail transportation.

The LPG markets are seasonal and Williams faces periods of high demand interspersed with relatively lower levels of demand. To compete successfully in both types of markets, Williams requires responsive, reliable and economical rail service.

As in many industries, in the LPG industry Williams faces widespread competition. The key to success is to provide better value. Providing better value requires that we look at the entire supply chain.

Supply Chain Management, simply stated, organizes a cost effective flow and storage of materials, in-process inventory, finished goods and related information from point of origin to point of consumption to satisfy customer requirements. For Williams Energy Services, transportation is an important segment of the LPG supply chain.

[1] Based on Williams LPG carload originations as percentage of rail carload originations for petroleum products (STCC 291), as compiled by AAR.

2. A Win-Win-Win Approach to Supply Chain Challenges

Our approach is based on Win-Win-Win. We see three winners in the Williams Energy Services Supply Chain:

- Williams Energy Services
- Williams Energy Services customers and suppliers
- Our partner Railroads connecting Williams Energy Services with its customers and suppliers

Our LPG supply and distribution capabilities depend on efficient and effective rail partners. In transportation, as with many other areas, we systematically explore alternatives in our search for the best methods of production and delivery.

As part of this process we define alternatives that will enable the three partners in the supply chain to achieve their objectives. This means that we regularly and thoroughly evaluate:

- Feasible production alternatives
  - Production location and volume
- Feasible transportation alternatives
  - Current Mode
  - Current Carriers

- Alternate Modes and
- Alternate Carriers

In a Supply Chain review process we evaluate the alternatives to make sure production and transportation generates the best combined option.

3. The Future

Demand is expected to remain strong, equaling or exceeding the overall growth in the economy. But competition will remain keen as new and evolving LPG companies contend in the marketplace.

Every element of cost in the supply chain is important. Companies will grow and prosper through both building traditional investments and through building strategic alliances. We see strategic alliances with our transportation partners as essential to continued growth and success.

4. Logistics Alternatives

Williams was founded as a pipeline company; and has grown into related fields by recognizing potential and moving energetically to realize that potential.

Today Williams moves LPG inputs and products using rail, truck, pipeline and water carriers. Williams has extensive experience in the efficient use of all four modes. Williams' relationships with the transportation carriers ranges from customer to

owner. Building and strengthening the relationships with its rail partners is one of the more important initiatives in the plan to build strong and competitive supply chains.

The STB has an important role in shaping the future of rail transportation. Williams sees this proceeding as crucial to the continued development of competitive rail service and the Supply Chains that rely on rail.

C. Background

After considering the extensive written comments, as well as the statements delivered in person at its 4-day hearing, the STB concluded that the rail community is not in a position to undertake what would likely be the final round of restructuring of the North American railroad industry. It further concluded that its current merger rules are not adequate for addressing the broad concerns associated with a merger process that could lead to just two large North American transcontinental railroads.

Accordingly, the STB announced that it would not accept further merger filings involving a major transaction (defined at 49 CFR 1180.2(a)) until it had the opportunity to revise its merger rules and put them in place. The principal purposes of this proceeding is to develop those new STB merger rules.

I have based my analysis on my prior experience planning and participating in rail mergers, acquisitions and divestitures, as well as on analysis of both the record developed at the STB's hearings and filings pursuant to STB Ex Parte No. 582 initiated on January 24, 2000 to obtain public views on the general subject of major

rail consolidations and the present and future structure of the North American railroad industry. The purpose of this statement is to report my analysis of the issues raised in Ex Parte 582.

I note that a decision from the US Court of Appeals on reopening BN-CN merger is due on June 13, 2000. Since the Court is reviewing the STB's decision to defer consideration of the BN-CN merger, its decision could impact this proceeding.

III. SUMMARY OF APPROACH

For Williams Energy Services rail transportation forges important links in its Supply Chain. Supply Chain Management is the process of organizing the cost-effective flow and storage of materials, in-process inventory, finished goods and related information from point of origin to point of consumption in orc'er to satisfy customer requirements. An effective supply chain joins the supplier, the producer, and the final customer in a continuum. For Williams Energy Services many of the most critical links involve the railroad system.

While mergers can create efficiencies, by definition they also reduce alternatives. As the data in Appendix B indicate, many of the WILLIAMS points are sole served by a single rail carrier. This heightens the importance of reliable rail service and tends to limit alternatives when rail service falters.

Williams Energy Services has sustained declines in rail service and increases in cost as a result of recent rail mergers. As with many other shippers, the rail service problems have caused:

- Diversions to alternative modes
- Curtailment of production
- Declines in equipment utilization
- Difficulties in meeting customer needs

Williams seeks to prevent recurrences of these types of supply chain defects in the future. In this regard, the data reported in Appendix B demonstrate:

- WILLIAMS points which are now served by only one rail carrier, with limited access to competitive alternatives in part due to recent mergers

- WILLIAMS points which are at risk of the loss of competitive alternatives due to the recently proposed BN-CN merger

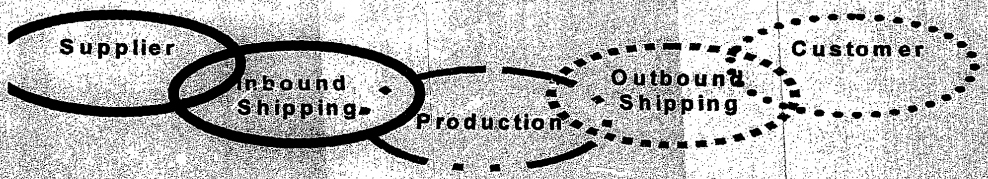
- WILLIAMS points which could sustain the loss of competitive alternatives due to the expected mergers responsive to BN-CN.

The experience of past mergers emphasizes the importance of transport alternatives as a remedy for weakened and broken supply chain links. Unfortunately, recent rail mergers, presumably intended to improve efficiency, have instead too often eroded competitive options and diminished alternatives.

From the perspective of our customers the Supply Chain produces a customer experience. The success of that experience results from a chain of contacts the customer undergoes in obtaining our products. Each link in the chain represents a contact and builds or erodes the value generated by the Supply Chain. The overall value and the success of the customer experience often is determined by the

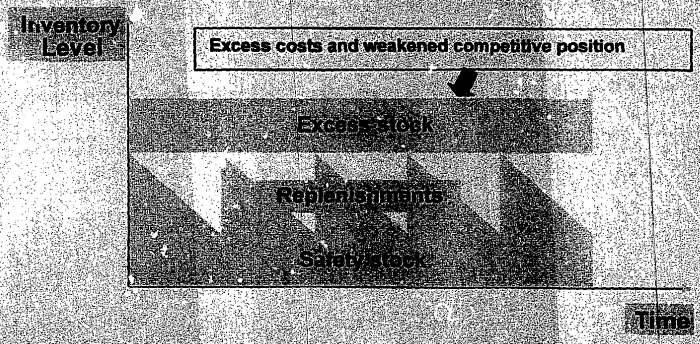
weakest link. Rail service after some recent rail mergers has often been the weakest link in the supply chain. The following chart sketches the process and illustrates that a broken link often amounts to not partial performance but overall failure of the supply chain.

The Supply Chain Determines The Customer Experience



When reliability falters, costs inevitably rise. This puts the entire supply chain at risk. Controlling inventory costs is an immediate byproduct of improved rail service reliability. As shown on the following chart, faltering reliability may lead to a near term response of increasing the safety stock. As the safety stock becomes excess, costs rise, the efficiency of the supply chain degrades and the customer looks to alternative sources.

Decreasing Transportation Reliability leads directly to
More excess stock and Increased Inventory Costs



The Surface Transportation Board (STB) has the opportunity and the duty to develop a vision of the future of the rail system that will:

- Remedy the defects that surfaced in recent rail mergers and
- Enhance the efficiency of the supply chain available to the nation's shippers.

The rail merger guidelines at issue in this proceeding are an important step in implementing this vision. At a minimum, they can prevent further erosion of the rail supply chain. Hopefully, they can contribute to its strengthening. We note that the STB espouses enhancing, rather than merely preserving competition and we endorse that.

This analysis outlines, in part through analogy with other industries vested with the public interest, the structure of the rail industry most conducive to competitive efficiency. Recognizing that designing a new rail structure is not a goal of this merger guideline proceeding, I offer suggestions on achievable and effective policy options that would advance the efficiency of the rail system by providing shippers with additional tools for their supply chain management.

IV. Williams

A. Company Overview

The Williams Companies, Inc., the parent company of Williams Energy Services, is a major entity. The aggregate market value of the voting stock held by nonaffiliates as of the close of business on March 15, 2000, was approximately $20 billion.

The Williams Companies, Inc. was incorporated under the laws of the State of Nevada in 1949 and was reincorporated under the laws of the State of Delaware in 1987. The principal executive offices of Williams are located at One Williams Center, Tulsa, Oklahoma

Williams Energy Services, a wholly owned subsidiary of Williams, requested that I make this independent assessment of the issues in Ex Parte 582 (Sub –No.1).

Williams, through Williams Gas Pipeline Company and Williams Energy Services and their subsidiaries, engages in the following types of energy-related activities:

- transportation and storage of natural gas and related activities through operation and ownership of five wholly owned interstate natural gas pipelines and several pipeline joint ventures;

- exploration and production of oil and gas through ownership of 1.05 Tcfe[2] of proved natural gas reserves primarily located in New Mexico, Wyoming, and Colorado;
- natural gas gathering, processing, and treating activities through ownership and operation of approximately
  - 11,200 miles of gathering lines, ten natural gas treating plants, and
  - 12 natural gas processing plants (one of which is partially owned)
  - natural gas liquids transportation through ownership and operation of approximately 13,360 miles of natural gas liquids pipeline;
  - transportation of petroleum products and related terminal services through ownership or operation of approximately 9,170 miles of petroleum products pipeline and 75 petroleum products terminals;
  - production and marketing of ethanol and bio-products through operation and ownership of two ethanol plants (one of which is partially owned);
  - refining of petroleum products through operation and ownership of two refineries;
  - light hydrocarbon/olefin transportation through 300 miles of pipeline in Southern Louisiana;

[2] "Mcf" means thousand cubic feet, "MMcf" means million cubic feet and "Bcf" means billion cubic feet. "Tcf" means trillion cubic feet. "Tcfe" means trillion cubic feet equivalent. "Btu" means British Thermal Unit, "MMBtu" means one million British Thermal Units and "TBtu" means one trillion British Thermal Units. "Dth" means dekatherm. "MDth" means thousand dekatherms. "Mbbl" means one thousand barrels. "GWh" means gigawatt hour. "MW" means megawatt.

- ethylene production through an interest in a 1.2 billion pound/year facility in Geismar, Louisiana;
- distributed power services;
- retail marketing through 227 convenience stores and 42 travel centers; and
- energy commodity marketing and trading.

Williams, through Williams Communications Group, Inc. and its subsidiaries, engages in the following types of communications-related activities:

- owner and operator of approximately 26,000 route miles of telecommunications fiber optic network;
- video services and other multimedia services for the broadcast industry;
- customer-premise voice and data equipment, sales, and services including installation, maintenance, and integration; and
- network integration and management services nationwide.

To achieve organizational and operating efficiencies, Williams' interstate natural gas pipelines and pipeline joint venture investments are grouped together under its wholly owned subsidiary, Williams Gas Pipeline Company. The other energy operations are grouped into a wholly owned subsidiary, Williams Energy Services.

1. Competition in natural gas

The FERC continues to regulate each of Williams' interstate natural gas pipeline companies pursuant to the Natural Gas Act and the NGPA. However, competition

for natural gas transportation has intensified in recent years due to customer access to other pipelines, rate competitiveness among pipelines, customers' desire to have more than one transporter, and regulatory developments. Future utilization of pipeline capacity will depend on competition from other pipelines, use of alternative fuels, the general level of natural gas demand, and weather conditions.

Williams understands the competitive access issues facing the rail industry. Suppliers of natural gas are now able to compete for any gas markets capable of being served by pipelines using nondiscriminatory transportation services provided by the pipeline companies. As the regulated environment has matured, many pipeline companies have faced reduced levels of subscribed capacity as contractual terms expire and customers opt to reduce firm capacity under contract in favor of alternative sources of transmission and related services.

2. WILLIAMS ENERGY SERVICES

Williams Energy is comprised of four major business units: Exploration & Production, Midstream Gas & Liquids, Petroleum Services, and Energy Marketing & Trading. Through its business units, Williams Energy engages in energy production and exploration activities; natural gas gathering, processing, and treating; natural gas liquids transportation, fractionation, and storage; petroleum products transportation and terminal services; ethanol production; refining; ethylene production; light hydrocarbon/olefin transportation; convenience store retailing; and energy commodity marketing and trading.

Williams Energy, owns or operates approximately 11,200 miles of gathering pipelines (including certain gathering lines owned by Transcontinental Gas Pipe

Line Corporation but operated by Midstream Gas & Liquids), approximately 13,360 miles of natural gas liquids pipelines, ten natural gas treating plants, 12 natural gas processing plants (one of which is partially owned), 75 petroleum products terminals, two ethanol production facilities (one of which is partially owned), two refineries, 269 convenience stores/travel centers, and approximately 9,170 miles of petroleum products pipeline.

Physical and notional volumes marketed and traded by subsidiaries of Williams Energy approximated 18,889 TBtu equivalents in 1999. Williams Energy, through its subsidiaries, employs approximately 7,760 employees.

3. MIDSTREAM GAS & LIQUIDS

Williams Energy, through Williams Field Services Group, Inc. and its subsidiaries, Williams Natural Gas Liquids, Inc. and its subsidiaries, and Williams Midstream Natural Gas Liquids, Inc. (collectively Midstream Gas & Liquids), owns and operates natural gas gathering, processing and treating, and natural gas liquids transportation, fractionation, and storage facilities in northwestern New Mexico, southwestern Colorado, southwestern Wyoming, eastern Utah, northwestern Oklahoma, Kansas, northern Missouri, eastern Nebraska, Iowa, southern Minnesota, Tennessee, and also in areas offshore and onshore in Texas, Alabama, Mississippi, and Louisiana.

Midstream Gas & Liquids also operates gathering facilities, owned by Transcontinental Gas Pipe Line Corporation, an affiliated interstate natural gas pipeline company, that are currently regulated by the FERC. Expansion Projects.

During 1999 Midstream Gas & Liquids continued to expand its operations in the Gulf Coast region through the Mobile Bay projects.

On April 1, 1999, Midstream purchased a 10 million barrel underground storage facility from Koch Industries. The facility is located west of McPherson, Kansas, and consists of 85 underground NGL storage wells. In addition, the purchase included loading/unloading facilities to accommodate 20 tank railcars and three tanker trucks. Storage facilities like this help insulate Williams from fluctuations in the market.

4. PETROLEUM SERVICES

Williams Energy, through wholly owned subsidiaries in its Petroleum Services unit, owns and operates a petroleum products pipeline system, two ethanol production plants (one of which is majority owned), and petroleum products terminals.

a) Rail alternatives: Pipeline Transportation.

A subsidiary in the Petroleum Services unit, Williams Pipe Line Company, owns and operates a petroleum products pipeline system that covers an 11-state area extending from Oklahoma to North Dakota, Minnesota and Illinois. The system is operated as a common carrier offering transportation and terminalling services on a nondiscriminatory basis. The system transports refined products and liquefied petroleum gases. This is an alternative means of transportation for some rail shipments.

5. Bio-Energy.

WEV, doing business as Williams Bio-Energy, is engaged in the production and marketing of ethanol. Williams Bio-Energy owns and operates two ethanol plants for which corn is the principal feedstock. The Pekin, Illinois, plant has an annual production capacity of 100 million gallons of fuel-grade and industrial ethanol and also produces various coproducts and Bio-Products. The Aurora, Nebraska, plant (in which WEV owns a 74.9 percent interest) has an annual production capacity of 30 million gallons. Williams Bio-Products also markets ethanol produced by third parties. Bio-Products, mainly flavor enhancers, produced at the Pekin plant are marketed primarily to food processing companies. This plant is a major source of rail freight.

6. Memphis Refinery.

The Memphis Refinery, which includes three petroleum products terminals, two of which were acquired in 1999 from Truman Arnold Companies, is the only refinery in the state of Tennessee and has a throughput capacity of approximately 160,000 barrels per day. During June 1999, the refinery's alkylation unit was expanded approximately 4,000 barrels per day to 12,000 barrels per day.

Williams Energy is also constructing a 36,000 barrels per day continuous catalyst regeneration reformer, slated for completion in May 2000. The reformer will enable the refinery to produce 100 percent of customer demand for premium gasoline in the mid-South region of the United States. The Memphis Refinery is a major source of rail freight.

The Memphis Refinery produces gasoline, low sulfur diesel fuel, jet fuel, K-1 kerosene, refinery-grade propylene, No. 6 fuel oil, propane, and elemental sulfur. The Memphis Refinery has access to crude oil from the Gulf Coast via common carrier pipeline and by river barges. In addition to domestic crude oil, the Memphis Refinery has the capability of receiving and processing certain foreign crudes.

B. WILLIAMS Experience with Rail Mergers

Despite the extensive experience in transportation management, as outlined in this section, Williams, like many other rail-served companies, has encountered sever problems in recent rail mergers. This proceeding offers an opportunity to develop better procedures, learning from the recent rail mergers.

V. Service, Reporting and Procedural Changes

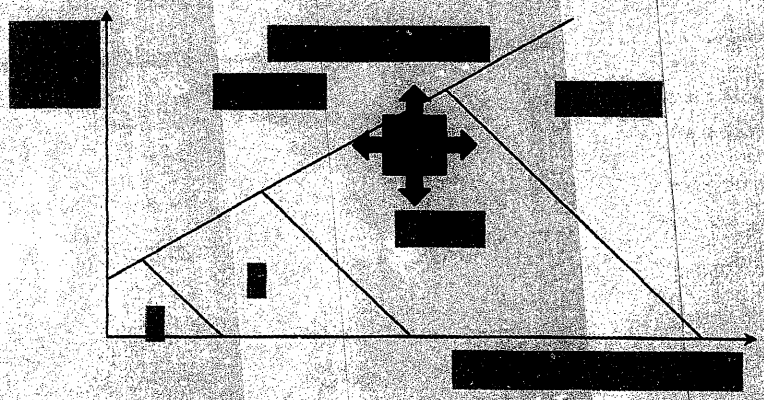
A. Introduction

Williams is concerned, as are many other rail shippers, with adequacy of rail competition and service. Shipper concerns have grown more intense in recent years as a result of mergers.

In this section we focus on service. Declining performance of the rail link, such as occurred in recent mergers can lead to serious dislocations in logistics and supply chain processes as illustrated in the following chart.

B.

Williams seeks to make the merger process more predictable and manageable



C. Service Measurement

To anticipate and prevent or correct service problems, measurement of the process is essential. Rail industry measurements include car inventory, system velocity, trains held for power or crews or congestion, locomotive power availability, rail system productivity.

Measurement must include not only the metrics of importance to rail management but also those of importance to the rail customer and to their end customers. While degradation in the rail management metrics often correlates with degradation in the customer metrics, it is preferable to measure the reliability, consistency and timeliness of delivery from the customers perspective, as well as from a blocking plan or railroad timetable perspective.

Incentives and disincentives can be built into the process based on the metrics. The design of the process is important. Customer service issues particularly need well designed measurements. And customer service includes many discrete issues, some of which are not easily measured. Some of the most important service issues include:

- continuity in understanding of customer's needs and wants
- ability to deliver necessary customer service levels
- variations between operating plans and actual implementation
- effective communications with the customers
- identifying and resolving differences among supplier's, railroad's and customer's perceptions of satisfactory service levels.

One of the major benefits asserted by railroads involved in a merger is the efficiency gains associated with single line service. However, single line operations are often accompanied by declines in both competition and service. The number of railroads handling the shipment between origin and destination is of minor concern to most rail customers. Typically, the rail customer is more concerned with reliability, competitive alternatives and adequacy of performance by the serving railroad.

Shippers not producing or receiving time sensitive freight tend to be primarily concerned with maintaining service at consistent and reliable levels. Large fluctuations in transit times, both inbound and outbound, have severe impacts on the supply chain. Past mergers have resulted in interruptions in production, lost freight cars leading to lost sales, and the threat of plant shutdowns.

The specific alternatives discussed below are suggestions on how to minimize or even eliminate the service failures that occurred as the result of past mergers. The following discussion also identifies actions that could reestablish some of the competition that has been lost between rail carriers during the merger process.

D. Operational Alternatives:

1. Line-Haul Service

The next round of mergers will create two transcontinental rail systems. Shipper options into and out of the major gateways will be severely reduced and in some instances eliminated. The major gateways can be broadly defined as those locations where four or more railroads currently interchange traffic or there is a switching railroad that handles the pickup and delivery of rail cars within the switching limits of the locality.

The major gateways that will be impacted by the formation of transcontinental rail systems will include:

- Chicago, IL,
- St Louis, MO including East St. Louis,
- Memphis, TN,
- Kansas City, MO and
- New Orleans, LA.

The newly merged systems will attempt to maximize their length of haul in order to capture the highest portion of the line-haul revenue as possible. This will be especially true of commodities that yield the greatest revenue margins, such as coal and chemicals. As the options at the origin and destination points have been continually reduced with each merger the serving carrier has gained more control over the line-haul routing of the shipment.

As a condition of all future mergers, especially those resulting in transcontinental railroads, the STB should establish a mechanism that will set reasonable rates

separately into and out of the major gateways when the railroads fail to allow for interchanges at major gateways.

The next step in the merger sequence is creation of transcontinental railroads. Transcontinental railroads will basically eliminate a rail shipper's ability to negotiate separate rates into and out of major gateways. Even with the existing limited number of railroad systems there are at least two railroads into and out of all major gateways. Soon, the shipper would be limited to a choice of using one of the merged systems from origin to destination. Under this situation the shipper's choice may be confined not to the most direct and efficient route but rather to one of the merged systems.

2. Local Service

Mergers have continually reduced the number of locations with multiple carrier service options. This trend can be reversed by opening up shippers in a locality to service by another railroad through reciprocal switching. Shippers that are located within the switching limits of a locality only served by one railroad would benefit, as would the second serving railroad newly providing the line-haul service to that locality.

a) Reciprocal switch

The reciprocal switching charge could be set at a reasonable level by the STB if the two railroads involved cannot reach an agreement. In order for the arrangement to be fair to both involved carriers, the difference in switching rates per car and the volume handled under the two facility agreement should offset to the greatest extent possible. All reciprocal switch charges would be absorbed by the line-haul railroad through the rate.

Providing access through this mechanism is preferable to trackage rights in high density traffic areas, especially industrial yard locations. Under the reciprocal switch arrangement, the carrier owning the switching facility does not have to accommodate the trains of another railroad on its system. By contrast, scheduling trains over trackage rights can lead to operating problems in terminals with a high traffic density.

b) Terminal switching railroads

A second possible solution is the incorporation of joint agencies or terminal switching railroads that are owned by the line-haul railroads that serve the locality. Railroads such as the PTRA in Houston, TRRA in St. Louis and the service provided in the Shared Asset Areas by Conrail provide examples of this. In certain circumstances this type of organization is more efficient in its operations and provides the rail customer better service.

3. Pre-Merger Safeguards:

With the exception of the BN-ATSF, and CN-IC, mergers in recent years have resulted in severe service disruptions with major adverse impacts on the operations of rail customers.

Operational planning exercises were carried out by the merging railroads in each instance and were intended to eliminate the service disruptions that occurred. The STB through its oversight procedure has monitored the operations of the railroads in the post-merger environment. Identified below are some of the more important areas of a newly merged system which often appear as the cause of service problems. We suggest procedures in each area to reduce or eliminate similar service disruptions in future mergers.

a) Rail Car Tracing and Identification

Car tracing and car identification systems in the merged system have been major problems for shippers. Often simply locating the car has seemingly been impossible. When located, cars were often mis-categorized between loaded and empty. The problems this simple error causes are easy to visualize. The shipper expecting to receive an empty car discovers it is loaded. Simultaneously another receiver is cutting into safety stock to make up for the missing shipment. Since the car is already loaded, the intended lading does not ship on time and another supply chain begins to sag.

I recommend that in the future, the STB should be presented with documented evidence that the systems of the merging railroads have successfully been "merged" in a simulation setting and also run in parallel with the systems of the individual railroads. This will demonstrate to the railroads, shippers and the STB the compatibility of the different systems and can increase the probability that the merged system will be functional on day one of the post-merger environment.

b) Computer and Data Systems

The electronic transmission of operating data is often cut over to the combined system on a piecemeal basis. If the merged system is to operate and conduct business as a single unit it must have compatible systems for every facet of integration.

I recommend that the integration of the different systems be tested in a real time setting. A realistic test of the merged system can be developed by applying it to the entire operations of the merged system using actual data. When such systems have been tested in the past, the volume of through put data has often been on a limited scale with the full scale test occurring during actual operations. Perhaps larger scale or full scale test results should be provided to the STB as proof that the systems will function as required in the post-merger environment.

c) Establishment of Operating Benchmarks

The current procedures of the STB's oversight of mergers are to establish operational benchmarks such as train speed, cars in the system, dwell time and car throughput in major terminals, etc.

I recommend that the train speed and cars in the system data should be developed for major operating divisions of the system in addition to the system as a whole. As the merged rail systems increase in size, statistics for the entire system may not reveal problems in specific geographical areas until the problem begins to adversely impact the entire system or rail network.

I recommend developing statistics that will give early indications of trouble spots within the merged system. Benchmarks can and should be developed and established in a pre-merger environment. Changes in these benchmarks post-merger would alert the operations personnel and the STB to potential problems that could be developing.

I recommend along these same lines, the development of tonnage densities for all major traffic corridors. Railroads have merged while rationalizing their infrastructure to the extent that capacity constraints could become an issue in the next round of mergers. Moreover, rail transportation in certain commodity groups has shown continued growth. This was cited as one of the underlying causes for the congestion on rail lines exiting from northern New Jersey, in the NS-CSXT-CR merger. The maximum density and the current density should be computed for all major corridors in order to assure the STB that the capacity exists for future growth. This could also be used to evaluate the train operation plan presented by the merging railroads.

While some may assert that the railroads already do all this as part of their merger planning process, the results suggest a bit more planning and testing is needed before the next "live fire" exercise.

I recommend in connection with tonnage density, that data be developed for the top ten commodities or commodity groups and the system as a whole for each of the merging railroads. This data should illustrate the trends for these products over the last five years for which the data is available. The months of the current calendar year for which data is available should also be included. The data should

include the number of tons, loaded car miles, and the total ton-miles. Increases in these statistics could signal rail planners as to increased requirements for motive power, train crews and rail cars. The data could also be compared with the traffic projections included in the application.

d) Procedural Time Frame

Mergers filed with the STB and ICC in recent years have been handled under increasingly ambitious time frames.

I recommend a more moderate time frame for future mergers. There should be sufficient time to test the process and solve the problems before turning the results loose. The STB could issue scoping orders calling for study of specific critical parameters. This order might address market analysis, operating plan, labor, traffic diversion study, and other key aspects. The merging railroads would be given adequate time to respond to the questions raised by the STB or other parties to the proceeding. This could help to identify and resolve issues that are perceived by certain parties to be potential problems with the merger plan.

E. Inclusion of Canadian Railroads:

Canadian railroads have been included in mergers with U.S. railroads in the past. As evidenced by the application of the BNSF and CN-IC, Canadian railroads will in all likelihood be included in future mergers involving U.S. railroads. As these systems become more integrated, the cost of operating the merged system will tend to be more heavily influenced by the characteristics of the Canadian operations.

In adjudicating a rate proceeding that involves a merged system that includes the CN or CP, the STB and the non-railroad party must have accurate cost data.

If the operations are truly merged the financial and operating data for the merged system should be filed with the STB in the same manner and format as is currently required of the U.S. railroads. If the shipment is handled in the U.S. over lines of both the BNSF and CN, for example, there is no method to subdivide the through rate and challenge the BNSF portion separately.

While, the current reports of the U.S. railroads would continue to be filed with the STB, if the rate structure continues to develop single line rates involving both Canadian and U.S. railroads it will be increasingly difficult for shippers to identify or contest unreasonable rates.

I recommend as a condition of allowing the merger of Canadian and U.S. railroads the STB should require that all financial and operating data be filed for the combined system on the basis currently required of U.S. railroads. To allow the U.S. portions of the merged system to continue to file separate reports will not produce true costs, representative of the combined operation.

VI. REVIEW OF THE ISSUES

I have carefully reviewed the key issues discussed in the STB March 31 decision. Based on this review, I believe these issues can be grouped into three categories:

- Issues where STB apparently sees a need for change in the merger rules
- Issues where STB might see a need for change in the merger rules
- Issues where STB apparently does not see a need for change in the merger rules

A. Issues Where STB Apparently Does See a Need to Change Existing Merger Regulations

1. Promoting and Enhancing Competition

The STB now appears much more receptive to altering rail merger policy to enhance, rather than simply preserve, competition. Among the competition-enhancing elements of recent mergers has been the concept of "Shared Assets Areas" which were initiated in the recent Conrail merger to open up competition between CSXT and NS. I note in passing that operations have not necessarily been made more efficient by the simple addition of another potential carrier

Both the UP-SP and CSXT-NS-Conrail mergers included negotiated agreements granting trackage and haulage rights to competing carriers. . More work is needed in this area.

During hearings in Ex Parte No. 582, some parties suggested other means to promote and enhance competition in the rail industry. These candidate remedies included requiring merger applicants to:

- Open gateways for all major routings.
- Provide switching, at an agreed-upon fee, to all exclusively served shippers located within or adjacent to terminal areas.
- Offer, upon request, contracts for the competitive portion of joint-line routes when the joint-line partner has a bottleneck segment.
- Provide a new through route at a reasonable interchange point whenever they control a bottleneck segment and the shipper has entered into a contract with another carrier for the competitive segment.

Others advocated revising the application of the so-called "one-lump" theory to rail mergers. Following that theory, the Board has declined to require access to additional carriers by exclusively served shippers whose sole carrier sought to merge with one of several connecting carriers. Shippers have urged the Board to provide exclusively served shippers with access to an additional carrier, through trackage rights, in order to promote and enhance, rather than merely preserve, competition

I recommend enhanced competitive access. Simply put, it is necessary to the preservation and expansion of competition and the consequent efficiency of the railroad system. It will be beneficial not only to shippers, but to the railroads. Subsequently in this statement, I discuss the long-term industry restructuring that the STB should be considering, and the near-term actions that might be adopted in the context of revising the merger rules.

1. Recognition of Downstream Effects.

The STB apparently recognizes that each major merger precipitates further mergers. It therefore proposes to eliminate the "one case at a time" rule and to examine "downstream" effects, including likely strategic responses to major merger proceedings by non-applicant railroads.

I **recommend** requiring a complete study of the downstream effects of subsequent mergers. The technology enabling such downstream studies has been widely available for more than a decade.[3]

2. Impact on Rail Service.

The STB recognizes that serious service disruptions were associated with recent mergers, disruptions which caused significant harm. Accordingly, the STB appears receptive to suggestions on additional service safeguards. Candidate remedies noted by STB include:

- Performance measures to evaluate post-merger service;
- More detailed periodic reports of post merger operations;
- More detailed service integration or implementation plans, with enforceable penalties;
- Required plans for preserving service options available to small shippers;
- Assurances of acquisition of new infrastructure and capacity; and

[3] Snavely King has routinely performed such studies for its clients for years.

- More detailed review of the financial terms with a view toward minimizing future service disruptions and any harm that could result from any such disruptions.

I recommend substantially increasing the requirement for reliable metrics in the service area as part of the merger application process. As the experience in Houston illustrates, the railroads eventually will master the operating problems and restore acceptable service. Requiring better planning can move the false starts back onto the drawing boards and out of the switching yards.

B. Issues where the STB apparently <u>might</u> change existing merger regulations

<u>1. Short Line and Regional Railroad Issues</u>

The STB appears interested in requiring applicants to submit plans for promoting the viability of existing regional and short line railroads. It might also consider the generic "Bill of Rights" advocated by the American Short Line and Regional Railroad Association. Among the "rights" of such railroads are the right to compensation for service failures, the right to interchange and routing freedom, the right to competitive and nondiscriminatory pricing, and the right to fair and nondiscriminatory car supply.

I recommend studying this set of issues carefully and considering extending to shippers the same "rights" deemed appropriate for small railroads. In past merger studies we have found substantial commonality of impact and interests between small railroads and shippers.

2. Employee Issues.

Rail labor groups have suggested that the STB require merger applicants to agree to forgo any effort to "cram down" post-merger changes in collective bargaining agreements and/or to offer their employees expanded labor protection (e.g., 10, rather than 6, years of benefits).

3. "Three-to-two" Issues.

Many parties have suggested that STB should give greater weight to competitive harm where the number of rail carrier alternatives would be reduced by a merger from three to two. It appears, however, that the STB is undecided whether to modify the regulations or handle this case-by-case examination.

I recommend that the STB accord the 3 to 2 situations importance comparable to that accorded to the 2 to 1 points. Williams still has some 3 to 2 and 2 to1 points left. Many other shippers have seen that competitive access virtually disappear. The STB should take firm steps to preserve the remaining competitive options.

4. Merger-Related Public Interest Benefits.

Many parties have suggested that STB should be more vigorous in securing public interest benefits of a proposed merger and that it should monitor the merger's implementation to ensure that the projected benefits are actually realized. Some parties have suggested that applicants demonstrate that claimed synergies or other public interest benefits could not be achieved short of merger through marketing alliances or cooperative operating practices.

I recommend that the STB increase the weight accorded to public interest in its decision making process. The balance between private interests of the merging parties and the public interest of the shipping and consuming public needs to be restored.

C. Issues where the STB apparently does not see a need to change existing merger regulations

1. Safety Issues.

STB asserts that safety concerns will remain a primary goal in railroad merger cases, but it intends to stay with the current approach applied on a case-by-case basis.

I recommend that safety, a paramount interest in the petro chemical industry, remain a primary goal in rail mergers.

VII. Analysis of Key Issues

In considering the key issues, I reviewed not only the record in this case but also the Supply Chain and logistics concepts WILLIAMS is implementing as part of its business planning.

Based on my review of these issues, and illuminated by the efforts of WILLIAMS and other major shippers in planning for and responding to recent rail mergers, my analysis focuses on three key issues:

- **Downstream Effects.** I believe it is critical that the STB anticipate the impact of any further mergers on the structure of the rail industry. Based on its ANPR, STB appears ready to broaden its view on this issue, and I encourage it to do so.

- **Competition.** I agree with a significant number of shippers and smaller railroads (and apparently the STB itself) that new rules must ensure that competition is not curtailed by future mergers.

- **Service Quality.** I also agree with the many parties who argued that additional safeguards are necessary in STB merger regulations to ensure that future mergers are not accompanied by serious or prolonged service disruptions.

Since these issues are closely linked, they will be discussed together in the context of the overall trends in the rail industry. I begin with downstream effects.

1. Downstream Effects

The STB states that it definitely intends to eliminate its "one case at time" rule and to consider "downstream effects" including the likely strategic responses of non-applicant railroads. The practical reality is that approval of any further mergers is tantamount to launching the final consolidation of the industry, almost certainly into two transcontinental railroads. In a few years, the STB will be confronted with a transcontinental rail duopoly.

Duopolies tend to generate weak competition. This is because each duopolist tends to market its products and services with the other duopolist in mind. Any price, product or service change by one competitor will often be met by an offsetting move by the other. This arrangement leads to very conservative marketing programs, that is, a tendency not to "rock the boat" by challenging the other duopolist too forcefully. In fact, duopolists are likely to engage in a pattern of tacit market sharing. Each participant knows that if it drives the other from the market, the government, which might tolerate a duopoly, will likely step in if threatened with a full monopoly. This is particularly true of an industry as critical to the public interest as the railroads.

In the rail industry, the weakness of duopoly competition will be amplified by the fact that most shippers will be physically located on either one or the other of the two systems. This provides each carrier with a long list of customers over which it has considerable market power. Indeed, in the absence of some sort of regulatory

intervention, the future rail structure could be viewed less as a duopoly than as a pair of parallel monopolies, each with its own core group of captive customers.

To be sure, there is inter-modal competition. The competitive threat of the pipeline, motor carrier and barge industries does constrain railroad rates for many commodities and movements. But the economic efficiency of relying on different modes of transportation to restrain the railroad prices suffers from severe limitations. While it may encourage efficiency for some types of traffic, it also results in cross-commodity subsidies, where the commodities/movements threatened by inter-modal competition are underwritten by those for which such competition is lacking. There is no incentive to price rail-dominant traffic in an efficient manner.

Left alone, the new structure of the rail industry may render intramodal rail competition a thing of the past. A possible result could be a railroad system that competes only for marginal traffic, that overcharges and underserves captive traffic, and that has little incentive to enhance the efficiency of its operations.

2. Responses to Market Concentration

If a transcontinental duopoly is the inevitable outcome of the current round of mergers, then the STB should develop policies that anticipate that inevitability. The objective of these policies should be to support competition wherever possible and, where competition is not possible, to protect the shipping public through continued regulation. In the short run, this involves preserving the limited competition that

currently exists and identifying the "choke points" where rail carriers are able to exert monopoly pricing power.

In the long run, this policy involves the injection of competition into the existing system. Ultimately, this approach may require opening institutional barriers that have traditionally been viewed as proprietary rights of the railroads. This long-range view reflects the fact that the railroads, once active competitors to each other, may soon cease to compete. Their role must be reconsidered. Rather than competitors themselves, they could be viewed as providers over which many competitors can operate. As experience in other industries indicates, this structural arrangement can produce significant benefits for the carriers as well as the shippers.

3. Examples from the Utility Industries

To understand the nature of this reconsideration, it is useful to examine the experience of other industries where the traditional proprietary controls of the incumbent providers have been relaxed so that competition, and the efficiency that it fosters, can flourish. In every case, the public has benefited, and the traditional providers have also reaped enormous rewards.

a) Telecommunications

The telephone system was once considered the classic "natural monopoly." The Bell System, controlled by the American Telephone & Telegraph Company (AT&T), owned most of the telephone handsets and other terminal equipment on

customers' premises, handled virtually all of the long-distance telephone service, and operated over 80 percent of the telephone lines in the nation. Independent telephone companies were no more competitive. Each had its own franchised monopoly service territory.

All telephone prices were set by regulation. Interstate long distance rates were regulated by the Federal Communications Commission, and rates for local and intrastate service were regulated by the state public utility commissions.

In the 1960's and 1970's a number of competitive entities successfully challenged AT&T's self-asserted right to monopolize the telephone terminal equipment market, and the FCC subsequently required AT&T to divest its ownership of these assets. Almost overnight, AT&T's monopoly disappeared, regulation of telephone equipment prices ended, and the market, not regulators, determined not only the prices, but the style, makeup and technological sophistication of telephone terminal equipment.

The result of this mandated relaxation of the proprietary right of the Bell System to own and control the telephone equipment market has been an explosion of innovation, a dramatic reduction in prices, and a vast expansion in the range of equipment available to the public.

AT&T also fared well despite the loss of secure, vertically integrated markets. Through a series of corporate transformations, AT&T now survives as Lucent Technologies, one of the world's most successful and profitable producers of telecommunications equipment.

The next challenge was leveled at AT&T's dominance of the long-distance market. MCI, Sprint and others demanded that they be allowed to interconnect with the Bell System first for "private line" services, and then for switched service. This effort culminated in 1984 with the breakup of the Bell system into seven local exchange telephone companies and a separate, independent entity that provided competitive long-distance service.

Again, the effect on the incumbent monopolist was beneficial, notwithstanding its prolonged efforts to resist the intrusion of competition into its markets. During the five years following divestiture, AT&T doubled its annual plant additions, yet its return on investment skyrocketed. In 1984, AT&T's equity return was 8.03 percent. Ten years later, in 1994, it was 29.9 percent.[4]

The final challenge to monopoly power in the telephone industry occurred when Congress passed the Telecommunications Act of 1996. This legislation required the incumbent local exchange telephone companies to open their systems to access by competitive providers. These pro-competitive provisions included mandatory permission to resell any telephone company service, collocation of competitors' equipment in the telephone companies' offices, and sale of "unbundled network elements" such as the telephone lines between the local switching offices and the subscribers' premises. Once the local companies opened their systems to competition, they would be allowed to re-enter the long-distance markets from which they had been excluded in 1984.

[4] FCC Statistics of Common Carriers, Table 14 (1984); Table 2.9 (1994).

b) Natural Gas

The natural gas industry of the early 1970s was heavily regulated from the wellhead to the burnertip. Market power was firmly in the hands of the interstate pipeline companies. Pipelines purchased gas from wellhead producers at regulated rates and transported it to the "city gate" for resale to the local distribution companies, which then delivered it to end-use customers. The pipelines' price, also regulated, was a "bundled" rate that included the commodity cost, transportation, storage, handling and delivery.

Independent gas producers had virtually no market power and depended entirely on the pipeline companies to get their product to end users. Then, as now, the exploration and production of gas (and hence the level of proven reserves) depended upon the price producers could get for their gas. As a consequence of artificially low regulated prices for interstate gas, a perceived shortage of gas developed in 1976-1977.

This crisis precipitated the Natural Gas Policy Act of 1978, which removed the regulation of the wellhead price of gas for interstate sale. The subsequent restructuring of the natural gas industry, however, was largely instigated by the regulatory agency, the Federal Energy Regulatory Commission ("FERC"). In FERC Orders 436 (1985) and 500 (1987), pipeline companies were given incentives to transport third-party gas, rather than the gas of their own merchant subsidiaries. In 1992, FERC promulgated Order No. 636, which made open access transportation and storage of third-party gas mandatory. This order completely separated the merchant (sales) function from pipeline transportation services. All gas, regardless

of its owner, is now transported under the same non-discriminatory rates, and any party, pipeline, local distribution company, or end-use customer can buy gas at the wellhead.[5] As a result, a new class of participants, the gas marketer, has become an important link in the supply chain for natural gas.

What has been the effect of this deregulation and restructuring? Initially, gas prices tripled, but the effect was to dissipate, almost immediately, the perceived shortage of gas reserves. Once wellhead prices stabilized, they held relatively steady up to the beginning of this year, when they were influenced by the OPEC-stimulated runup in energy prices caused them to increase again.

The effect on pipelines was extraordinary. A 1999 study of the largest pipeline parent companies (representing 88 percent of all interstate pipeline revenues) revealed that the FERC's requirement to abandon the gas merchant function caused their revenues to decline by 41 percent, from $17.9 billion to $10.6 billion between 1992 and 1997. Their expenses, however, declined apace, from $13.0 billion to $5.0 billion, with the result that there was a negligible contraction in net income, from $2.7 billion to $2.4 billion. While there were considerable investments in the industry during these years, most related to corporate consolidation.[6] Since 1996, however, the industry's construction expenditures have increased

[5] In fact, most gas is purchased at market centers, of which there are several dozen.

[6] "Corporate Realignments and Investments in the Interstate Natural Gas Transmission System," by Susanne Johnson, Jon Rasmussen, and James Tobin, Energy Information Administration/Natural Gas Monthly, Octover 1999.

dramatically, from approximately $1.2 billion to $3.5 billion in 1999 and a projected $5.0 billion in 2000.[7]

The same restructuring that occurred for interstate pipelines is now under way at the local level. Local distribution companies are being encouraged, and in some states required to open their system to gas purchased by end-use customers directly from competing marketers. This open access policy allows consumers to seek out the lowest prices both for wellhead gas and for the transportation and storage of that gas. The consuming public can expect further savings from these changes.

c) The Electric Utility Industry

Like the telephone industry, the electric utility industry has long been considered a "natural monopoly." It has been dominated by vertically integrated entities, most of them private corporations, that hold exclusive franchises to sell electricity to all customers within their designated service territories.

A major justification for the "natural monopoly" of electric utilities was the economies of scale of power generation. In general, the size of the generating plant and the cost of the power generated were inversely related. Cheap electricity required very large power plants. However, about 1990, technological developments, most notably the development of combined cycle combustion turbines, cancelled this traditional relationship between plant size and cost.

[7] Energy Information Administration, Financial Analysis Team, Office of Energy Markets and End Use.

Suddenly, small plants could be built that generate power as cheaply as large ones. This meant that small, independent entrepreneurs could produce electricity competitively with the incumbent electric utilities. For the first time in history, competition could be introduced into the electric generation industry.

This potential competition immediately encountered the ownership ties of a vertically integrated system. The same incumbent utilities that controlled the existing power plants also controlled the transmission system and the distribution network. Competitors may be able to generate electricity efficiently, but they had no way of reaching their customers except over the lines of the incumbent utilities. Those utilities had little incentive to accommodate the new upstarts.

The Energy Policies Act of 1992 addressed this problem squarely, at least for the FERC-regulated wholesale markets. That Act created a new class of Exempt Wholesale Generators ("EWGs"), which are entities that generate power for sale but which are unrelated to any of the incumbent utilities in the region. Those entities would be entitled to equal and non-discriminatory access to the incumbents' transmission systems at tariff rates filed with the FERC.

The 1992 Act applied only to federally regulated wholesale power, that is, power generated for resale, somewhere between 10 and 20 percent of the nation's total. Retail competitive access to end-use customers is a state matter, since retail electric service is under state commission jurisdiction.

As one would expect, different states have taken different approaches to this issue. In general, the states with the highest electric rates – northeast and California –

have addressed retail access most aggressively. Most states have required that the transmission grid be placed under independent control to deprive the incumbent of any opportunity to favor its own generators over those of its competitors. Some states gone so far as to required its incumbent utilities to divest their generating assets. At this writing, every state in the nation except South Dakota is in the process of opening its electric transmission and distribution system to some form of open access.

And how have the incumbents fared through this process? Last year, Snavely King conducted a study of the 43 sales of generating plant assets that had taken place between mid-1996 and mid-1999. We found that the dollar-weighted average sale price of the generating plants that had been sold was approximately twice the book value of the plants. Since the book value was the basis for the utilities' profit allowances, the effect of the sales was to double the earnings capabilities of these utility companies' assets.

Competitive access to retail electric customers has thus been a bonanza to the electric utility industry, yet it is safe to say that not one utility advocated it. The principal proponents of open access have been the industrial consumers of electricity, who recognized that the market would provide them with the leverage to create significant savings for themselves and their customers. Paradoxically, their self-interest has redounded to the benefit of the incumbents who resisted open access most vociferously.

d) Relevance to the Rail Industry

The foregoing examples drawn from the utility industries demonstrate quite clearly that a high level of industry concentration is not necessarily inconsistent with the development of effective and beneficial competition. To the contrary, the incumbent monopolists (or duopolists) can function as enablers, rather than inhibitors of competition, and they can benefit to the same degree – if not more – as the new competitors.

In order for the incumbents to fill this role, I see two fundamental changes in modus operandi of the industry. First, there must be a clear identification of the activities that can be opened to competition and a separation of them from those functions that continue to be intrinsically monopolized.

The electric utility industry affords a good example. It is universally recognized that power generation lends itself to competition but that the transmission and distribution functions continue to be natural monopolies. Power generation is opened to all competitors and is deregulated. Transmission and distribution continue to be subject to regulation. Similarly, in the telephone industry, subscriber access is recognized as the bottleneck function of the telephone industry that will continue to be dominated by the incumbent carriers. Meanwhile, long distance telephone service, for which competition is feasible, is offered separately by highly competitive firms.

Second, there necessarily must be some intrusion by governmental authority into what the incumbents have traditionally perceived as their proprietary rights.

Ironically, the successful introduction of competition requires this intrusion. For example, competition in the telephone equipment market required a governmental mandate that AT&T surrender its proprietary right to own and control all equipment attached to its network. Competition in the long-distance market was possible only when the government altered the corporate structure of the Bell System. Competition in the local exchange market required the government to force the incumbents to interconnect competing carriers. Competition for gas procurement required a governmental prohibition against gas pipelines functioning as gas merchants. Competition in the electric industry can be effective only when existing transmission grid owners are forced to provide equal access all generators of power.

It is not difficult to apply the utility restructuring model to the railroad industry. The railroads provide two quite distinct functions: they own and maintain railroad tracks, and they own and operate railroad trains over those tracks. Both of these functions are generally controlled entirely by the same entities, and both will become subject to the anti-competitive effects of the impending transcontinental duopoly.[8]

The ownership of railroad tracks is arguably a monopoly function. It is often infeasible to expect competing entities to share the provision of rights-of-way.[9] The

[8] There are other related functions such as the provision of railroad cars that are somewhat competitive already.

[9]Although, as the "Shared Asset Areas" of the northeast corridor suggest, even this assumption may be open to question.

experience with the NSC-CSXT-CR acquisition suggests however that even provision of the right of way can support two separate entities in certain markets. The operation of trains, however, clearly is not intrinsically a single-provider activity and could be opened to competition. Again, the electric utility analogy suggests itself. The transmission lines (the line haul component, like rail lines) are centrally controlled and operated by a single entity. The power that feeds onto those lines, however, is generated by a variety of competing firms. The competitors pay the transmission entity for the right to use the lines, but the power (functionally similar to rail freight) flows to customers designated by the generators at prices determined by a very competitive market.

4. Policy Options

While it is relatively simple to identify the potentially competitive functions within a monopolized rail industry, the second change required for effective competition, which is the government intrusion into the incumbents' perceived propriety rights, is a far more difficult proposition. The following discussion addresses the broad categories of policy solutions that suggest themselves. We have included a set of summary charts in this report evaluating these options against 12 different criteria.

a) Maximum Rate Regulation

If the railroads are to consolidate into two entities for the entire continent, then a case might be made for the reregulation of the industry. This reregulation would be limited to traffic that has no demonstrable intermodal competition, and it would

establish only maximum rate levels. The railroads would be free to reduce rates at their discretion. It would thus be lighter-handed than the regulation that prevailed prior to the Staggers Act, but it would represent a marked increase in the regulatory role currently played by the STB.

This policy option has the appeal that it could be an effective solution to the pricing power of the railroads, but its efficiency is questionable. Moreover, it would be costly to administer for the STB, the railroads, and the shippers whom it presumably would benefit. Although I am not an attorney, I believe it would also require revision to the statutes that currently govern the regulation of the railroad industry.

I recommend against reregulation. In my opinion, reregulation is an outdated solution, whose time has passed. The trend in the utility industries, discussed earlier, has been to harness the market as the most efficient form of price regulation. Heavy government regulation has particularly ill-served the railroad industry and is users.

b) Resolution of the Bottleneck Impasse

If total re-regulation is infeasible and undesirable, and I believe it is, there is a much more limited application of regulation that would substantially enhance the protection that shippers require from the pricing power of heavily concentrated railroads. It concerns what are called "Bottleneck" situations. Bottleneck situations occur when there is a movement involving multiple railroads, but at either origin or destination (or both) only one railroad can pick up or deliver the traffic. The sole originating or sole terminating railroad is termed the "bottleneck" carrier. The rate

charged by this carrier for its portion of the total rail movement is defined as the bottleneck rate.

The STB has established some fairly constraining criteria that must be met before a shipper can challenge a bottleneck rate. The first criterion is operational. There must be no reasonable alternative service from another railroad or mode of transportation.

The second criterion is commercial. A rate challenge of the bottleneck rate is disallowed unless the balance of the total rail rate, excluding the bottleneck rate, is a contract rate. Under existing regulations, the STB does not regulate contract rates. The STB's rationale is that two parties entering into a contract do so under mutual consent, and a contract is legally binding on both parties unless certain situations occur. Therefore, if the total transportation charges are part contract and part tariff, the STB would only be able to adjudicate the non-contract portion. Thus, the only rate that could be challenged would be the non-contract tariff portion, the bottleneck rate.

Under existing STB rules, in movements involving multiple railroads where the entire rate from origin to destination is a combination of proportional rates or local rates, the rate of the bottleneck carrier cannot be challenged on its own merits, in isolation from the remaining published rates. When these circumstances are present, all of the rates applicable to the particular movement must be challenged by the rail user. This position has been upheld by the appellate courts based on a Supreme Court decision which found that a shipper's interest in challenging a rate is on the entire rate and not a portion of that rate. Despite a widely held view in the

shipper community that this was not the intended application of this principle, it is the standard currently applied.

As indicated above, the ability of a rail customer to challenge a bottleneck rate is currently available only under restricted circumstances. The next round of mergers could further reduce the number of situations under which bottleneck rates can be challenged separate from the total through rate.

With the likelihood of combining rail systems currently transporting shipments in between the east and the west, the substitution of single-line through rates for movements that are currently a combination of contract and tariff rates is a distinct probability. The merged system has only to let the contract expire and publish a joint- line or single-line rate from origin to destination. Under the current bottleneck rules, this would require the rail customer to challenge the entire rate. Agreements could be made between the railroads to maintain the current rate levels of the individual carriers but file them collectively as a single through rate. This would protect the bottleneck carrier from having its rate challenged.

As railroads merge into larger systems they will wield more influence over shortline railroads, who in many situations, are the bottleneck carriers. A bottle- neck shortline carrier can eliminate a challenge to its effective rate by including its rate in the through rate published by its connecting Class I carrier. If it cannot reach agreement with the connecting railroad on a division share of the through rate, it can publish its own rate. As long as the balance of the rail movement is not occurring under a contract, the shortline's individual published rate cannot be challenged under the current bottleneck guidelines.

If the rate cannot be challenged as a bottleneck rate, the only existing regulatory remedy available to the rail customer is to file for rate relief under the non-coal rate guidelines, Ex Parte No.347 (Sub-No.2), or the coal rate guidelines, Ex Parte 347 (Sub-No.1)..

Neither of these regulatory options is particularly effective or efficient. The cost of a maximum rate case under the Ex Parte 347 (Sub-No.1) guidelines can easily exceed $1,000,000. Given the fact that a significant number of such cases result in no rate relief, many shippers have dismissed maximum rates cases as a viable course of action. The development path on the non-coal rate guidelines, Ex Parte No.347 (Sub-No.2) has been prolonged and laborious. However, again, little if any rate relief has resulted from the process. If the cost and expected return of instituting these complex proceedings does not justify the relief sought, the rail customer is effectively precluded from any rate relief from the STB under existing regulations.

Mergers are likely to increase bottlenecks, the instance of through rates, and the corresponding vulnerability of shippers to the pricing power of bottleneck carriers.

I recommend a reasonable, but restrained application of the STB's regulatory authority to require, as a condition for future mergers, that shippers be permitted to challenge bottleneck rates regardless of the nature of any other rates in the movement between origin and destination. When a railroad sets a proportional or local rate as its revenue compensation, that rate would then be subject to rate reasonableness tests on its own merits.

Bottleneck rates are unique in that they are largely shielded from regulatory review. The proposed bottleneck rate relief would remove this shield and allow the rate to be evaluated on its own merits. This policy option is immediately available to the STB, it can redound to the benefit of shipper and railroad alike, and it may increasingly be needed in the context of the final round of mergers.

c) Build Out to Competing Rail

As an alternative to paying bottleneck rates, a shipper can, in theory, build his own rail line. This alternative is theoretically always available to shippers seeking intra-modal competition.

I **recommend** that it should be supported by the STB as a countervailing force against unreasonable rail rates or inadequate rail service. It is, of course, prohibitively expensive to most shippers. Except in relatively rare instances, it is simply not practicable.

d) Open Access

A case might be made for a complete restructuring of the railroad industry similar to that which was imposed on the telephone and gas industries and which is currently under way in the electric utility industry. Under this scenario, the rail line ownership function might be decoupled from the train operation function. Any party capable of operating a train would then have access to the rail rights-of-way by paying regulated access charges. If the railroads chose (or were allowed) to continue to

operate trains, they would do so in competition with other railroads, with shippers, and possibly with non-rail train operators.

Again, this is a somewhat radical approach, one that would probably require legislative authority for the STB to implement. It does, however, have a certain amount of conceptual appeal, and should be examined as a possible long-term solution. If adopted, it would have to be implemented very carefully to avoid operational problems that could disrupt the rail system. Barring a major change in attitude on the part of the railroads, it would encounter their vociferous opposition.[10]

e) Limited Open Access

Short of full open access, a number of limited open access strategies can improve the opportunities for shippers to enjoy the benefits of intra-modal competition. These strategies can be grouped functionally. First, there are **operational** innovations such as:

- Haulage rights, where the freight of the entering carrier is hauled to serve the target market in the trains of the incumbent carrier.

- Trackage rights, where the trains of the entering carrier reach the target market by operating over the track of the incumbent carrier.

[10] However, as the history of the utility restructurings has demonstrated, the opposition of the incumbents was neither insurmountable nor in the incumbent's own self interest.

- Joint Facilities, where the entering carrier and the incumbent carrier agree to jointly build a facility or cooperatively use an existing facility, thus lowering costs and increasing service. Storage in transit facilities are an apt example.

There are also **commercial** solutions, which include arrangements whereby marketing and rate making authority is extended into markets not otherwise competitively served.

Examples of these solutions are found in Canada, where rail duopoly has been a reality for most of the country's history. The Canada Transportation Act provides two mechanisms that allow Canadian shippers to access either of the line-haul carriers. The first is Interswitching; the second is Competitive Line Rates.

Interswitching applies if a shipper has access to only one rail carrier at origin or destination. The shipper may have cars interswitched from the serving carrier to another railroad at prescribed rates if shipper's siding is within a 30-kilometer radius of the point of interchange. The 30-kilometer limit is not rigid, however, and can be extended. The rate must not be less than the variable costs of moving the traffic.

Competitive Line Rates (CLR) apply if the shipper has access to only rail carrier at origin or destination and a continuous route between those points is operated by two or more companies. The shipper must be beyond the 30-kilometer interswitching limit. In these circumstances, the local carrier could be required to establish a competitive line rate from the origin or destination to the nearest interchange with a connecting carrier. However, the shipper must first agree to

rate, terms, etc. with connecting carrier. Any portion of the move covered by an interswitching rate will use that rate. Shippers must show they will suffer "substantial commercial harm" if the Canadian Transport Agency does not grant CLR.

CLR provisions have seen limited use due to requirements that shipper and line-haul carrier agree on rates before CLR is determined, and the shipper show "substantial commercial harm" if CLR is not granted. However, the availability of these provisions has enhanced shippers' competitive options in the marketplace, without actual regulatory intervention.

As the Canadian experience illustrates, limited commercial access solutions are available without significantly altering the existing regulatory framework. The Interswitching arrangement is similar to our recommended reciprocal switching and bottleneck rate recommendations.

f) Regulatory Merger Oversight

The final policy option is "business as usual" in the merger review process. It is to approve each merger with a series of specific conditions and requirements that are to be reviewed after the fact by the STB through its oversight process. This is the "one at a time" practice that the STB appears intent on abandoning. And for good reason.

Its effectiveness in preserving competition is limited because it requires that the merger review anticipate all possible anti-competitive outcomes from the

combination. It addresses the narrow specifics of each merger without considering the systemic decline in intra-modal competition throughout the continent. Finally, it creates an after-the-fact remedial arrangement that reacts to, rather than anticipates, plans for and prevents the unexpected and adverse effects of each merger.

B. Summary Review of Options

Monetary, Geographic and Commodity Constraints on Policy Options

Option	Monetary Cost of solution to Shipper	Monetary Cost of solution to Railroad	Geographic constraints on Option Applicability	Commodity constraints on Option Applicability
Maximum Rate Regulation	High	High	No	Yes
Resolution of Bottleneck rate impasse	Low	High	Yes	No
Build Out to Competing Rail	High	High	Yes	No
Open Access	Low	High	Yes	No
Limited Open Access Via Haulage Rights	Low	Low	No	No
Limited Open Access via Trackage rights	Low	Medium	Yes	Yes
Regulatory Merger Oversight	High	Low	Yes	Practical limits

It is necessary to consider the ongoing institutional constraints on policy options

Option	STB Resource Requirement for Solution	STB ongoing involvement in Solution	Regulatory constraints on Option Applicability	Legal constraints on Option Applicability
Maximum Rate Regulation	Major	Major	Major	Major
Resolution of Bottleneck rate impasse	Major	Minor	Medium	Minor
Build Out to Competing Rail	Medium	No	Medium	Minor
Open Access	Major	Minor	Major	Major
Limited Open Access via Haulage Rights	Minor	Minor	Medium	Minor
Limited Open Access via Trackage Rights	Minor	Minor	Medium	Minor
Regulatory Merger Oversight	Major	Major	Major	Major

The effectiveness, efficiency and track record of the policy options varies

Option	Effectiveness of Solution	Efficiency of Solution	Proven track record of Option	Experience with use of Option
Maximum Rate Regulation	High	Medium	Yes	Extensive
Resolution of Bottleneck rate impasse	High	High	Extensive in Negotiations area	Extensive in Negotiations area
Build Out to Competing Rail	High	High	Yes	Extensive
Open Access	High	High	Yes	Extensive in Negotiations area
Limited Open Access via Haulage Rights	Low	Low	Mixed Reviews	Limited
Limited Open Access via Trackage Rights	Medium	Medium	Yes	Extensive
Regulatory Merger Oversight	Low	Low	Limited	Limited

As the summary charts indicate, the policy options are numerous and their implications are diverse. As discussed in the preceding section, among the more promising options is limited open access, a policy option which could be implemented in a number of ways and which can meet the needs of both railroads and shippers.

VIII. Conclusion

The next round of mergers will almost certainly lead to the final consolidation of the railroad industry into two transcontinental systems. Without clear policy direction from the STB, this duopolized industry will lose its competitiveness and efficiency. If that happens, the supply chains with railroads as key links will themselves lose competitiveness. This can have significant adverse effects. The STB can prevent further merger disarray and damage by adopting two types of policy options. Based on my review of the rail industry and similar concentrated industries I recommend that the STB should adopt the following three key policy initiatives.

The first policy initiative would increase protection for shippers by permitting them to challenge a bottleneck rate on its own merits.

The second policy initiative would adopt a range of strategies for increasing access by shippers to alternative rail carriers.

The third policy initiative would develop and apply meaningful service benchmarks, incentives and guarantees as part of the merger review and monitoring process.

Failure to adopt these and similar pro-competitive policy initiatives, combined with the effects of the final wave of railroad mergers would seriously hinder a wide range of shipper industries and ultimately redound to the disadvantage of the railroads themselves.

The essential test of the regulatory policies is how efficiently and effectively they generate competitive alternatives. If the regulatory policy enables the creation of competitive alternatives, market forces will complete that process and generate mutually satisfactory solutions.

As shown in this statement, policy options are now available to the STB which can remedy the detrimental effects of the coming wave of rail mergers while promoting financial health of the entire supply chain; supplier, shipper, customer and railroad. I recommend that STB adopt the following responsive and effective policy options:

- **Bottleneck rates** Extend the proven regulatory threshold costs tests to enable challenging bottleneck rates.

- **Competitive Access.** Adopt a range of strategies for increasing access by shippers to the alternative rail carrier, including haulage rights, trackage rights, interswitching, and line haul access modeled on the Canadian competitive line rates.

- **Service.** Adopt relevant and meaningful service measurements and build in incentives to ensure adequate service is delivered

IX. Appendix A: Qualifications

Experience

Snavely King Majoros O'Connor & Lee, Inc., Washington, DC
Vice President (1988-Present)

Mr. O'Connor has more than twenty five years experience in the transportation industry. His experience includes key and increasingly responsible management and policy positions with government agencies and private industry.

Mr. O'Connor, in recent years has conducted analyses for the Government of Canada used to shape policy for freight transportation transport policy. He also has developed the Master Plan for Management Information Systems and computer facilities to measure, manage and monitor both rail freight and rail passenger transportation for the Bulgarian State Railways, in Bulgaria and the Balkan Peninsula. He has created and managed numerous computerized transport management and regulatory systems and is a widely recognized expert on costing and economics.

Mr. O'Connor has analyzed more than 45 rail merger scenarios and cases. He has provided expert testimony before state and federal courts and commissions in the U.S. and Canada on economic and policy issues. He has also testified as an expert on computerized transportation analytical systems, rail operations, anti trust issues and transportation costing. Mr. O'Connor also has served as an impartial and expert monitor of data and processes at issue in litigation on transportation.

Within the litigation arena, Mr. O'Connor has also conducted management audits of

railroads, focused on identifying the cause and effect relationships underlying claimed cost incidence. The management audits were directed toward testing the cost basis of bills submitted by major railroads.

DNS Associates Inc., Washington, DC
Vice President (1982 - 1988)

Mr. O'Connor directed and participated in numerous projects including merger analyses, transportation infra-structure analyses, plant and network rationalization and feasibility studies. He designed and implemented mainframe and microcomputerized systems for analyzing rail, truck and barge logistics. The computerized cost systems Mr. O'Connor created are in widespread use throughout the United States and Canada.

Mr. O'Connor also advised the U.S. Rail Accounting Principles Board on the costing aspects of regulatory reform policies. He also provided expert testimony on computerized data bases and cost systems and related rail cost issues before the Interstate Commerce Commission.

Association of American Railroads, Washington, DC
Assistant Vice President, Economics (1979 - 1982)

Mr. O'Connor designed and managed major economic analysis projects. He helped formulate industry economic policy positions culminating in the Staggers Rail Act of 1980. He submitted expert testimony on behalf of the railroad industry in numerous cases before the Interstate Commerce Commission and state regulatory

commissions. He also appeared regularly in national forums on economic issues.

Mr. O'Connor directed the most significant computerized industry Costing System project in 40 years, URCS, the cost system now used by all major US railroads. He also conducted industry seminars on URCS and related economic issues.

Mr. O'Connor also testified before the Interstate Commerce Commission on the design and application of this pathbreaking rail cost system since adopted by the Commission and the rail industry.

He also directed development and installation of a commercial computerized economic and market analysis system now used by virtually all major US railroads.

Consolidated Rail Corporation, PA

Assistant Director, Cost & Economics (1977 - 1979)

Mr. O'Connor was responsible for all Conrail management and regulatory cost analyses in both freight and passenger areas. He testified before the ICC on the development of subsidy standards now widely used in the US railroad industry. He also finalized the design, and implemented and managed Contribution Simulator and Calculator (COSAC), a computerized internal management economic analysis system at Conrail. The COSAC system uses specific management accounting data to develop economic costs. COSAC replaced earlier systems and was used to guide virtually all transportation management decisions.

Mr. O'Connor also participated in cost allocation negotiations between Amtrak and

Conrail on cost sharing of joint facilities on the North East corridor. He initiated and directed profit maximization and plant rationalization programs. He also designed and implemented computerization and improvement of a wide range of economic and cost analysis systems used to manage this multi-billion dollar corporation.

R.L. Banks & Associates Inc., Washington, DC

Consultant (1976 - 1977)

Mr. O'Connor conducted and directed numerous transportation- related projects in the U.S. and Canada ranging from national logistics analyses to site-specific studies. He specialized in costing systems and appeared as an expert witness on such systems in a precedent setting proceeding before a Canadian Crown Commission.

U.S. Railway Association, Washington, DC

Manager, Local Rail Service Planning (1974 - 1976)

Mr. O'Connor developed, computerized and implemented the light density lines cost analysis system, which defined Conrail. He served as liaison with congressional staffs and shipper groups, as well as federal, state, and local governments, and planning agencies. The system he created was a major element in the design and implementation of the streamlined Midwest-Northeast regional rail system. Mr. OConnor subsequently appeared as an expert witness to present and defend the operation of the USRA costing system.

Interstate Commerce Commission,

Economist, Washington, DC (1973-1974)

Mr. O'Connor served as a staff economist and authored a report analyzing industry

investment patterns and ICC regulatory policy, including ICC use of cost evidence.

Education

University of Massachusetts, Amherst, B.A. Economics
University of Wisconsin, Graduate Course Work, Economics
University of Delaware, Graduate Course Work, Business Management
The American University, Graduate Course Work, Computer Science

Professional Organizations

Transportation Research Board

- Former Chairman of Surface Freight Transportation Regulation Committee

Transportation Research Forum

- Former President of the Cost Analysis Chapter

National Defense Transportation Association

- Former Member of Board of Directors, National Capital Chapter

Phi Beta Kappa academic honors society
Phi Kappa Phi academic honors society

Military

U.S. Army; Sergeant, Combat Engineers

Security Clearance

Secret

X. Appendix B: Data and Analysis

Williams Movements - Alternate Carrier Analysis

	Origin Points 2 to 1	Comment	Origin Points 3 to 2	Comment
BNSF with CN/IC	Lemont, IL		None	
BNSF/CN-IC with NS	None		Hartford, IL	not including shortlines
			Des Moines, IA	not including shortlines
			Charlotte, NC	
UP with CSXT	None		None	
UP with NS	None		Des Moines, IA	not including shortlines
BNSF/CN-IC with CSXT	Nashville, TN	not including shortlines	Charlotte, NC	
	Sarnia, ON		Hartford, IL	not including shortlines

Points Currently Sole-Served

BNSF

Origin Points	Conway, KS	
	Mentor, MN	
	Sidney, MT	
	Belfield, ND	
	Fargo, ND	
	Lignite, ND	
	Mandan, ND	
	Taylor, ND	
	Tioga, ND	
	Aurora, NE	
	Cherry Point, WA	
	Ferndale, WA	
	Fidalgo, WA	
	St. Paul Park, MN	
	Huron, SD	not including shortlines
BNSF	Anacortes, WA	not including shortlines
Destination Points	37 points in 11 states	

Points Currently Sole-Served

CN

Origin Points	Beamer, AB
	Beamer/Redwater, AB
	Eckville, AB
	Elspeth, AB
CN	Lochearn, AB
Destination Points	None

Points Currently Sole-Served

CPRS

Origin Points	Chancellor, AB
	Copithorne/Jumping Pound, AB
	Home Oil Spur (Carstairs), AB
	Homeglen/Rimbey, AB
	McNeill, AB
	Minaret, AB
	Nevis, AB
	Pecten/Waterton, AB
	Rockyview, AB
	Ft. Whyte, MB
	Elbow River, MN

CPRS

Destination Points	5 points in 1 state

CSXT

Origin Points	None
Destination Points	7 points in 4 states

Points Currently Sole-Served

IC	
Origin Points	None
Destination Points	None
KCS	
Origin Points	None
Destination Points	2 points in 1 state
NS	
Origin Points	Doraville, GA
	Dragon, MS
	Greensboro, NC
Destination Points	1 point
UP	
Origin Points	Breaux Bridge, LA
	Marrero, LA
	Sutherland, NE
	Mt Belvieu, TX
	Millis, WY
	Patrick Draw, WY
	Tipton/Red Desert, WY

Points Currently Sole-Served

UP Destination Points	17 points in 9 states
VARIOUS SHORTLINES ONLY	
Origin Points	Mankato, MN
	Winnebago, MN
	Billings, MT
	Laurel, MT
Destination Points	28 points in 12 states

Note: Potential originating and terminating carriers shown are based on carriers serving city. Carriers serving actual plant/customer may be fewer.

Source: The Official Railway Guide, March/April 2000

SK **Snavely King Majoros O'Connor & Lee**
1220 L St NW Wash, DC 20005
Economic and Management Consultants

VERIFICATION

I, Tom O'Connor, declare under penalty of perjury that the foregoing statement is true and correct and was prepared by me or at my direction. Further, I certify that I am qualified and authorized to file this statement. Executed on May 15, 2000.

Tom O'Connor

Subscribed and sworn to before me this 15th day of May, 2000 in the District of Columbia.

Notary Public

My Commission expires: April 30, 2001

Notice of Service

Copies of this Verified Statement and the accompanying Comments were served by first class mail on the Parties of Record for Ex Parte 582 (Sub No.-1).

Tom O'Connor